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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1974

NO. 74-74-410

JAMES E. SMITH,

Petitioner

v.

THE UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioner, James E. Smith, prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Fourth Circuit, entered in the above entitled case on September 10, 1974.

OPINIONS BELOW

The opinions of the courts below directly preceding this petition are as follows:

1. Opinion and Order dated September 10, 1974, United States of America v. James E. Smith,- F.2d (4th Cir. 1974) (No. 74-1257) (Copy appended hereto.)

2. Judgment and sentence on jury verdict of guilty dated December 3, 1973, unreported. United States District Court For The Eastern District Of Virginia, Richmond Division.

JURISDICTION

The opinion of the Court of Appeals was entered September 10, 1974. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254.

QUESTIONS PRESENTED

(1) Whether the evidence is sufficient to establish with reasonable certainty an opening net worth figure; (2) Whether the evidence shows that Government Agents investigated any of Smith's activities in Washington, D.C. in the years prior to the tax years 1968 through 1970, or that leads regarding his activities or assets were followed; (3) Whether the evidence established a "likely source" of the alleged income or excludes "all possible sources" of non-taxable income; (4) Whether the evidence fails to allocate the alleged increases to particular tax years. (5) Whether there is evidence of an "attempt to evade" income tax liability for the tax year 1968.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This matter involves 26 U.S.C. §§ 7201 and 7203, which provide as follows:

§ 7201. Attempt To Evade Or Defeat Tax

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution. Aug. 16, 1954, c. 736, 68A Stat. 851.

§ 7203 Willfull Failure To File Return, Supply Information, Or Pay Tax

Any person required under this title to pay any estimated tax or tax, or required by this title or by regulations made under authority thereof to make a return (other than a return required under authority of section 6015), keep any records, or supply any information, who willfully fails to pay such estimated tax or tax, make such return, keep such records, or supply such information, at the time or times required by law or regulations, shall, in addition to other penalties provided by law, be guilty of a misdemeanor and, upon conviction, thereof, shall be fined not more than $10,000, or imprisoned not more than 1 year, or both, together with the costs of prosecution.

STATEMENT

James E. Smith was indicted on three counts of fraudulently attempting to evade or defeat his federal incomes taxes for the years 1968, 1969, and 1970 in violation of 26 U.S.C.A. § 7201 (1967). He was tried in the United States District Court For the Eastern District of Virginia.

Smith entered pleas of not guilty and was tried by a jury on September 4, and 5, 1973. At the conclusion of the Government's case in chief the defendant moved for a directed verdict of acquittal. (Tr. 202) This motion was denied. At the conclusion of the defendant's case the motion for directed verdict of acquittal was renewed and denied. (Tr. 255).

The jury returned verdicts of "guilty" on each of the three counts. The defendant then filed a written Motion For Judgment of Acquittal on September 12, 1973. It was denied. On December 3, 1973, the District Court sentenced the defendant to serve three years on each count.

Smith appealed and the judgment was affirmed by the United States Circuit Court of Appeals for the 4th Circuit on September 10, 1974.

THE STATEMENT OF THE FACTS

The Government proceeded to attempt to prove its case based upon the net worth method. The case consisted of the introduction of Smith's past tax returns for the years 1966 through 1970; a showing that he had not filed a return for the year 1968; and establishing the amounts of certain expenditures by Smith in the years 1968, 1969 and 1970.

Specifically, the Government attempted to prove that Smith's net worth at the end of 1967 was $3,700.00 and that his net worth increased as follows:

1968	1969	1970
$40,034.51	$67,960.63	$105,077.62

Smith's individual returns for the years 1966 through 1970 were introduced and reflected the following:

1966	$1,894.43	(James E. Smith) (GX-1)
1967	$4,368.00	(James E. Smith) (GX-2)
1968	No Return	(James E. Smith) (Tr.9)
1968	$6,835.15	(Barbara Smith) (GX-3)
1969	$8,124.00	(Joint Return with Barbara Smith) (GX-4)
1970	$7,950.00	(Joint Return with Barbara Smith) (GX-5)

H&R Block had prepared Mr. & Mrs. Smith's returns for 1969 and 1970 from information received from the Smiths. (Tr.18). In all, the Government introduced fifty-three exhibits in its attempt to show that Smith's income was substantially greater than that reported on his returns.

The defendant, originally from Richmond, had

lived in Washington, D.C., except for two years, from 1955 to 1967. In 1968, he returned to the Richmond area and engaged in his first enterprise, Smith Woodworking Co. This venture failed in that same year.

In 1969, Smith formed SHP Corporation, a construction firm. There were four shareholders - James E. Smith, Richard Smith, Arthur Pitchford and Joseph Harmon.

Several of these shareholders were called as government witnesses and testified that the business did not flourish. Harmon, the Vice-President stated:

Mr. Williams: Did there come a time when the corporation got into financial problems?

Mr. Harmon: Yes.

Mr. Williams: When was that?

Mr. Harmon: Oh, it was the year after it was started.

Mr. Williams: Your started when? 1969?

Mr. Harmon: '69.

Mr. Williams: So this would be when? Some time in 1970?

Mr. Harmon: Yes. (Tr.43).

Pitchford left the company because he could not live on the $150.00 salary he was paid. (Tr.39). Harmon, on occasion, refrained from taking his salary and then, finally, he too left. (Tr.43).

Corporate tax returns from 1969 and 1970 established that SHP did not realize any taxable income. In 1969, its gross receipts were $10,912.18 less than its cost of operation. (GX-6). And in 1970, SHP required loans from its shareholders to meet is expenses. These totalled $25,600 in 1970. (Tr. Vol. IV, 61).

Fred Gray testified that in 1969 and 1970,

Smith also had been in business, along with Fred and Warren Gray, in a corporation named Trio Investment Corporation. This company was founded in 1969 to purchase and hold rental properties. (Tr. 72-73). It too had no taxable income. (Tr. 32) (Tr. Vol. IV, 44) (GX-8,9).

Malcolm Wells, C.P.A., for SHP and Trio, testified regarding the income tax returns of SHP and Trio. Wells obtained his data from corporate records, checks and bank records. (Tr. Vol. IV., 22). In going over the corporate records, Wells noticed that the corporation's books had paid bills totalling more than their income. He further stated that from these records he deduced or assumed that there had been cash loans from stockholders to Trio and to SHP Corporation to make up these differences. (Tr. Vol. IV, 30).

Mr. Wells also stated that there was no way to tell whether these amounts were income or not, so he counted them as loans from stockholders to make the books balance out. (Tr. Vol. IV, 46).

Hugh L. Gay, an accountant who had testified in one previous net worth case, summarized the Government's evidence and submitted a chart for the Court and the jury to follow. (This chart did not go to the jury room). Mr. Gay stated that in deriving an opening net worth figure, he gave Smith no credit for any cash on hand as of December, 1967, and that no investigation was made of his assets in Washington, D.C. or his activities prior to his return to Richmond. (Tr. Vol. IV, 87-88).

His net worth was calculated to be as follows:

1967 - $3,700.00
1968 - $40,034.51
1969 - $67,960.63
1970 - $105,077.62 (Tr. Vol. IV, 73).

After adding personal living expenses for each year and deducting known, non-taxable sources Mr. Gay concluded that Smith had taxable income as follows:

1968 - $31,727.70
1969 - $29,964.76
1970 - $39,813.86 (Tr. Vol. IV, 82).

After deducting taxable income already reported by Smith, Gay concluded that Smith had failed to pay tax on the following sums:

1968 - $31,727.70
1969 - $25,515.76
1970 - $35,782.86 (Tr. Vol. IV, 82).

Also introduced was a financial statement submitted to a bank, signed by James E. Smith, showing total assets of $66,750.00. It was signed March 13, 1969. It showed $10,000.00 cash on hand; $5,750.00 in notes receivable; $36,000.00 in real estate; and $10,000.00 worth of automobiles. (GX-52; Tr.70).

Agent Clybourne of the Intelligence Division of the Internal Revenue Service testified that he interviewed Smith in early 1972. At that time, in response to his repeated questioning, Smith told him that the most money he had ever had on hand at one time was approximately $20,000.00 to $30,000.00. (Tr. 198). He stated he had no personal income for 1968, but that his attorney might have filed a tax return for Smith Woodworking, Inc., for that year. (Tr. 195).

Mr. Smith took the stand in his own defense and contradicted the Government's assertion that his net worth at the beginning of the calendar year 1968 was only $3,700.00, the prices paid for an automobile and a motorcycle. He stated that he had been employed in Washington, D.C. with the exception of two years from 1955 to 1967. He had gone there alone to make money. He lived with an aunt. He further stated that while there he worked as a parking lot attendant for $1.00 per hour. In addition he received tips which amounted to $15.00-$20.00 per day at first. (Tr.203). Later, he worked two jobs, one at Graphic Arts Press, the other at Kinney's Parking Lot. (Tr.214).

On pay days, he would gamble with fellow employees and others, and he won large amounts, $300.00-$400.00 per payday. (Tr. 210). Additionally, Smith, a large man, testified that he had been a prize fighter and that he had been paid by promoters at the rate of $500.00-$700.00 per fight. (Tr. 213,214). Furthermore, in 1963, Mr. Smith won a very large amount of money on "the numbers". He "hit" number 427 for $8,000.00. (Tr.217).

Smith also recounted that while in Washington he had lived a rather Spartan life with the hope that one day he could return to Richmond to open his own business. He paid his aunt $10.00 per week for room and board. (Tr. 208). Then, in 1968, Smith returned to Richmond and opened his first business, Smith Woodworking Co. This venture failed and he had no income that year. This, he stated was the reason no personal return was filed for 1968. (Tr.221).

Smith did admit, however, that he had earned several hundred dollars in 1969 by making cabinets for people. He voluntarily admitted that this income had not been reported for tax purposes. (Tr. 231).

The sum of Smith's testimony was that he had saved for over nine years to accumulate approximately $50,000.00. (Tr. 216). This money had been accumulated, not in the most desirable manner, i.e., through gambling and fighting, and he had paid no tax on it because he did not know that he had to. (Tr. 214).

Regarding this assertion of prior accumulated sums, Mr. Harmon stated that he had known James E. Smith all of his life and that he knew that Mr. Smith had accumulated a large sum of money prior to 1968 in Washington, D.C. (Tr. 47-48).

Richard Smith also stated that, though he had not seen the large sums of money Mr. Smith had accumulated prior to 1958, he knew about it. (Tr.53-54).

Henry H. Patterson, Jr., the general contractor who built Smith's home stated that Smith had paid him large amounts in 1968 toward the construction and purchase of a home. (Tr.101). He further stated:

(Janus:) Mr. Patterson, you first met Mr. Smith sometime approximately February, 1968, February or March?

(Patterson:) I did.

(Janus:) At that time he was not living in Richmond, he was living in Washington, D.C., is that correct?

(Patterson:) That is what I understood, yes sir.

(Janus:) At that time you understood from talking to him that he had money accumulated for which he was going to pay for the house, isn't that correct?

(Patterson:) That's right.

(Janus:) And this was back in early '68?

(Patterson:) Right.

REASONS FOR GRANTING THE WRIT

Introduction

Defendant Smith submits that this case merits review on certiorari because the decision of the Court of Appeals is contrary to rulings of this Court, in United States v. Massei, 355 U.S. 595 (1958); Holland v. United States, 348 U.S. 121 (1954); and Spies v. United States, 317 U.S. 492 (1943).

THE EVIDENCE WAS INSUFFICIENT TO ESTABLISH WITH REASONABLE CERTAINTY AN OPENING NET WORTH FIGURE

When the Government resorts to the net worth method of proving a violation of 26 U.S.C.A. § 7201 it calls on the outer limits of circumstantial evidence to carry its burden of proof. This method is heaped

in inference and consequently is riddled with pitfalls.

Holland v. United States, 348 U.S. 121 (1954) echoes this caveat. While not disapproving of the net worth method in principal, this Court did outline numerous pitfalls this type of prosecution contains and stated:

> "While we cannot say that these pitfalls inherent in the net worth method foreclose its use, they do require the exercise of great care and restraint." Id. at 129.
>
> "In recent years, however, tax-evasion convictions obtained under the net worth theory have comehere with increasing frequency and left impressions beyond those of the previously unrelated petitions. We concluded that the method involves something more than the ordinary use of circumstantial evidence in the usual criminal case. Its bearing, therefore, on the safeguards traditionally provided in the administration of criminal justice called for a consideration of the entire theory." Id. at 124-25.
>
> "In this consideration, we assume, as we must in view of its wide spread use, that the Government deems the net worth method useful in the enforcement of the criminal sanctions of our income tax laws. Nevertheless, careful study indicates that it is so fraught with danger for the innocent that the Courts must closely scrutinize its use." Id. t 125. (emphasis added).

This Court then went on to discuss the various aspects of the net worth method and, insofar as is relevant to the importance of the accuracy of the opening net worth figure stated the following:

> "We agree with petitioners that an essential condition in cases of this

> type is the establishment, with reasonable certainty, of an opening net worth to serve as a starting point from which to calculate future increases in the taxpayer's assets. The importance of accuracy in this figure is immediately apparent, as the correctness of the result depends entirely upon the inclusion of this sum of all assets on hand at the outset." Id. at 132. (emphasis added).

In Holland the Government had asserted that the opening net worth for the Hollands was $29,650.00 plus $2,153.09 in cash. The Hollands claimed however that they had accumulated "hundred and possibly thousands of shares of stock" which were on hand at the beginning of the prosecution period. This Court was unimpressed with this assertion because the Government had taken the extra step of negating any possibility of such an accumulation of wealth prior to the prosecution period by showing the hardship and deprivation that the Hollands had endured during the pre-prosecution era. The Hollands, while allegedly having over $100,000.00 and a cafe business, incurred $35,000.00 in debts which were never paid. They lost their household furniture due to an unpaid bill of only $92.20. They also suffered a default judgment and were forced to separate for eight years because of their poor economic condition. The Government also went to the extent of introducing Mr. Holland's income tax returns for as far back as 1913 which demonstrated that he had no ability to accumulate any such cache.

An assertion of prior accumulated wealth has been made in the case at bar. Mr. Smith has testified that from 1955 until 1967 he accumulated in excess of $50,000.00 in Washington, D.C. During that period he worked as a parking lot attendant and at several other jobs. He lived a sparse life in an attempt to accumulate funds to come back to Richmond, Virginia, to open a business. He gambled with his fellow employees and

was successful. He was a prize fighter and made substantial amounts of money in the ring. On one occasion he even "hit" the numbers for $8,000.00. This testimony is corroborated by several Government witnesses, who say they knew that Smith had a lot of money when he returned in 1968. (Tr. 47-48, 53-54, 103).

There is no evidence in Smith's case of any judgments, bankruptcies, financial hardships, or the repossession of any of his goods. In fact, the Government asserts that he owed no money until 1969.

Despite the assertion of accumulated cash, which was made at the outset to Agent Clybourne, (Tr. 180) the Government made no investigation into Mr. Smith's activities in Washington, D.C. prior to 1968. Yet, despite this, the Government maintains that Mr. Smith's net worth at the end of 1967 was a mere $3,700.00. And while the Government's calculations are based upon figures and expenditures relating to Richmond, Virginia, Smith did not actually move back to Richmond, Virginia until April, 1968. (GX-50). Prior to that time he had been making arrangements to come back.

In March, 1968, Smith was in a position to negotiate for the building of a new home for $29,000.00. In fact, In February, 1968, he paid $1,062.00 down (Tr. Vol. IV, 71). Yet three months earlier the Government would have the Court believe that Smith had only a car and a motorcycle.

It is the contention of the defendant that this $3,700 opening net worth figure is ridiculous. Agent Clybourne admitted on the stand that the defendant had made mention to him at initial contact of having had on hand at one time from $10,000 to $20,000. Yet there is not a single hint of any further inquiry into this matter by the Government.

In this vein, the defense would call the Court's attention to Merritt v. United States, 327 F. 2d 820 (5th Cir. 1964). There the Court, noting the circumstantial nature of proof when the net worth method is employed, noted that the Government's special agent had taken the stand and admitted that he knew that there were some other assets that could have been included in the

opening net worth statement. After the admission neither counsel for the Government nor counsel for the defense asked any further questions of this witness.

The Court went on to note in that case that "one of the most important element of the Government's proof in a net worth case is the establishment of an opening net worth." Id. at 821.

The Court in Merritt then noted pointedly that from a reading of Holland it was clear that:

> (T)he Government has not established its case until it has established with reasonable certainty an opening net worth. This would include listing or accounting for all assets of the taxpayer of which the Government is aware, either through its own investigation, or through the checking of leads furnished by the taxpayer. To hold otherwise would defeat the requirement that the Government both check and negate leads furnished by the taxpayer.....Id. at 822-23.

In the case at bar Mr. Gay made a statement similar to the one made in Merritt. He stated that it made no difference that items were possibly deleted from the opening net worth figure so long as they were not later included. However, what of assets that are sold and the cash then used to make purchases during a prosecution year? (Tr. Vol. IV 91-92). Of couse, that would affect the figures. (Tr. Vol. IV, 116). Compare United States v. Caserta, 199 F. 2d 905, 907, (3rd Cir. 1952).

What of Mrs. Smith's assets? No credit whatsoever is given Smith for any assets jointly owned or purchased by Mrs. Smith that they had prior to 1968. (Tr. Vol. IV, 91). Yet the Government includes Mrs. Smith in its computations during the prosecution years. Nor was mention made of gifts, inheritances, or loans to Mrs. Smith that could account for funds later spent during prosecution years. See United States v. Rully, 143 F. Supp. 283 (D. Conn. 1956).

Bell v. United States, 185 F. 2d 302 (4th Cir. 1951) is also helpful on the point regarding the burden on the Government to prove the opening net worth of the defendant. In that case, the defendant relied, inter alia, upon United States v. Fenwick, 177 F. 2d 488 (7th Cir. 1949). Though the Court distinguished Fenwick on its facts, it did not reject the principal contained therein.

In Fenwick, the Court stated,

> "The weakness of the Government's positions, stressed by the defendant, is the uncertainty of the propriety of the finding of defendant's net worth at the beginning of 1943. Of course, before the increased net worth method of proof is effective, the net worth of the taxpayer at the beginning of the tax year must be clearly and accurately established by competent evidence." Id. at 490.

In Fenwick, the Government had offered no direct testimony of unreported income. Therefore, the Court applied the rules of circumstantial evidence in holding that:

> "There is no proof that he had not accumulated cash or assets of other character over the 25 years during which he had been engaged in business.*** But defendant did tell the agent that he had been in business for 25 years and that in the five year period mentioned, he owned United States Savings Bonds which he had cashed.
>
> *** The agent said on cross-examination that he had made no inquiry of defendant as to whether he had cash on hand accumulated from earning from his business in the years prior thereto. * * *
>
> As we have said, when the Government relies upon the circumstances of increased net worth and expenditures in excess of reported income to establish income tax evasion it must produce evidence that it excludes all possible available

sources of taxable income from which the increase net worth and the excess expenditures could have been derived." Id. at 491 (emphasis added).

> "Essential proof of no other assets is the cornerstone of the evidence of the Government; that cornerstone being faulty, the whole edifice is so weakened as to be undependable as proof of guilt beyond all reasonable doubt." Id.at 492.

See also Comment, The Defense of a Criminal Net Worth Tax Case In The Light Of Recent Supreme Court Decisions, 41 Cornell Law Quarterly 106, 110 (1955).

The Government has not even attempted to negate the defendant's assertion of a much higher opening net worth. In fact, from the facts in the case the figure of $3,700.00 is patently absurd. Hence, since "the whole edifice", the opening net worth figure, is undependable the burden of proof of guilty beyond a reasonable doubt has not been met.

THE EVIDENCE FAILS TO SHOW THAT THE GOVERNMENT AGENTS INVESTIGATED ANY OF MR. SMITH'S ACTIVITIES IN WASHINGTON, D.C., IN THE YEARS PRIOR TO THE TAX YEARS 1968 THROUGH 1970, OR THAT LEADS REGARDING HIS ACTIVITIES OR ASSETS WERE FOLLOWED.....

There is no burden on the taxpayer to prove the Government's case. Merritt v. United States, Supra. at 823. To hold otherwise would encroach seriously upon the Fifth Amendment privilege and upon the basic principal that the burden of proof is upon the Government.

Judge Hutchesen of the Eastern District of Virginia in United States v. Riganto, 121 F. Supp. 158 (E.D. Va. 1954), worried however by the prospect quoted a passage worthremembering from Demetree v. United States, 207 F. 2d 892 (5th Cir. 1953):

> "This is another of the growing list of criminal cases in which the Government, having no or little direct evidence of defendant's guilt to offer and endeavor-

ing to prove it by circumstantial evidence, attempts to do so by what may be called the net worth and expenditures method of proof. In this attempt, unless the greatest care is taken by the district judge to prevent it, there is danger of the case being tried on a theory which, keeping to the ear the promise that a defendant is presumed innocent until his guilt is established beyond a reasonable doubt, breaks it to the hope by allowing a series of theoretical estimates and computations as to defendant's income to take the place of proof of it.

Sometimes conclusions from those computations and estimates are allowed to invade the province of the jury and furnish the basis for a conviction not upon evidence of facts but upon speculation and theorizing by the Government's witnesses as to what the facts really are.

Sometimes, without adhering to the essentials of the method that the net worth at the beginning as well as the end of the period be shown, the proof comes in and the case is submitted with a complete gap, in the proof as to the beginning of the period.

This kind of latitudinous allowance of the admission and use of conclusions as evidence and the submission of the case to the jury without a scrupulous adherence to the theory, has resulted in a tendency to accept if not in the complete acceptance of, the idea that in a case tried by this method, ordinary rules of proof may be relaxed if not disregarded. Further and more prejudicial to a defendant, there has grown up a kind of ancillary theory that the Government, by introducing proof of deposits, expenditures, etc., having put up what it calls a prima facia case, the defendant finds himself jockeyed

> out of the position the law affords him, of insisting that the Government establish his guilt by legal and credible evidence beyond a reasonable doubt. This is accomplished by requiring him to prove himself innocent by assuming the burden of overcoming the prejudicial effect of the mass of exhibits, estimates, conjectures, and conclusions which the Government has been allowed to get into the record, upon the apparent theory that it is up to the defendant to explain all of it away as part of his burden to prove his innocence." (emphasis added).

The danger here is somewhat attenuated, however, where the Government is required to check leads furnished voluntarily by the taxpayer. However, the Government must not be permitted to pick-and-choose which leads it will pursue. It must at least determine and prove the validity or invalidity of a given lead.

It is not enough that the Government states that it does not believe that investigation of a lead will net any significant result.

> "When the Government fails to show an investigation into the validity of such leads, the trial judge may consider them as true and the Government's case insufficient to go to the jury." Holland v. United States, Supra. at 136. (emphasis added).

In the case at bar there is no evidence that the Government made any investigation into Smith's activities in Washington prior to 1968. Tax records were furnished from 1966 to 1970 only - no tax records were introduced from the period prior to 1966. Compare United States v. Doyle, 234, F. 2d 788, (7th Cir. 1956).

For all of the above reasons, it is submitted that the Government, because of the failure to even check the

validity of Smith's story, has failed to prove with reasonable certainty Smith's true opening net worth. Hence, everything which was based upon that initial opening net worth figure is invalid.

THE EVIDENCE FAILS TO ESTABLISH A "LIKELY SOURCE", OR EXCLUDE " ALL POSSIBLE SOURCES" OF NON-TAXABLE INCOME

Again, our starting point is Holland v. United States, Supra. There it was stated:

> "Increases in net worth, standing alone, cannot be assumed to be attributable to currently taxable income. But proof of a likely source, from which the jury could reasonably find that the net worth increases spring, is sufficient." Holland v. United States, Supra. at 137-38.

This Court later expanded on this somewhat in United States v. Massei, 355 U.S. 595 (1958):

> "In Holland we held thatproof of a likely source was ' sufficient' to convict in a net worth case where the Government did not negative all the possible non-taxable sources of the alleged net worth increase. This was not intended to imply that proof of a likely source of income was necessary in every case. On the contrary, should all possible sources of non-taxable income be negatived, there will be no necessity for proof of a likely source. The above explanation must be taken into consideration in applying the Holland Doctrine in this case." Id. at 595-96.

Thus we are led to the conclusion that it is an "either or" situation insofar as establish prima facie that increases in net worth represent increases in taxable income."

In the case at bar the Government has not proved a likely sourch for the alleged increases in net worth for the years 1968 through 1970. The evidence in the case shows thatSmith came back to Richmond from Washington, D.C. in April, 1968, and that he began Smith's Woodworking Company. There is no evidence whatsoever that Smith's Woodworking Company made any money that year, and in fact Smith took the stand and stated that Smith's Woodworking made no money and that that was the reason he filed no personal income tax return for that year. (Tr. 195).

Insofar as 1969, 1970 are concerned there is evidence in this case that Smith was involved with Trio Investment Corporation and SHP Corporation. The income reported on Smith's tax returns is that which he received from SHP Corporation. (GX 4-7). There is no evidence of any other likely sources. Yet how likely are these sources? The Government proves that the corporations owed Smith money. In fact, to show Smith's net worth the Government attempted to show that he loaned Trio Investment Corporation $26,744.34 in 1969; that he loaned an additional $2,137.51 to Trio Investment Corporation in 1970; that he had a note receivable from Trio Investment Corporation in the amount of $1,030.00; and that his initial investments in Trio Investment Corporation for the years 1969 were $2,250.00 and $7, 000.00 in 1970. If Mr. Smith was making so much money from these corporations in income, why did they need loans from him and the other stockholders in order to keep going?

The alleged increases in taxable income correspond almost identically with what the Government contends are loans, etc. from Smith to Trio and SHP. Smith's increase according to their figures for 1969 was $25,515.76, while his reported loans to Trio were $26,744.34. His alleged increase in net worth for 1970 is $37,116.99 while his investment into Trio combined with his accounts receivable from SHP and accounts receivable from Trio equal $32,244.34

No where was it shown that Smith had received monies from SHP and Trio in order to turn right around and loan them back to the corporation. Again, it is the defendant's position that it is absurd for the Government to contend that these two corporations, neither making money in their initial years in operation, could be the sources of so much personal income to Mr. Smith. If anything, the Government's case demonstrates that the corporations were unlikely sources of income.

Therefore, since the Government has proved no other likely source of income to Smith the burden falls upon them to exclude all possible sources of non-taxable income. This they have not done. Compare Dupree v. United States, 218, F.2d 781 (5th Cir. 1955).

There is no testimony in the case at bar excluding inheritances, loans, or gifts, etc. to Mrs. Smith during the period. There is evidence that she received non-taxable retirement funds, but there is no evidence that she did not receive substantial sums of money which would account for the Smith's increases in net worth. There were no tax returns introduced for Mrs. Smith prior to 1968.

It must be remembered that the burden is not on the defendant to show the existence of non-taxable income, rather the burden is on the Government to exclude by competent proof all sources of non-taxable income.

Shortly after the Holland and Massei cases were decided United States v. Kleinman, 167 F. Supp. 870 (E.D.N.Y. 1958) was decided. There it was stated:

> "It is firmly established that increases in net worth, standing alone, cannot be assumed to be attributable to taxable income; there must be evidence to support such an inference." Id. at 872.

In Kleinman the defendant stated that he had lived frugally and made substantial savings in years previous to the indictment years. He also maintained that his father, whom he claimed as a dependant, had made gifts to him of approximately $12,000.00 per year. Although the Court felt that this testimony was "at best, unlikely," the Court went on to state that the... "Government's evidence merely established the improbability

of this fact. It does not establish its falsity." Id. at 876. The same is true of the case at bar.

On this point the Kleinman Court stated:

> "The net result is that there is a void as to a showing of a possible source of unreported income, and the persuasive value which such a showing might have is replaced only by speculation of no probative value whatever." Id. at 874.

Therefore, it is submitted that since there has been no competent evidence to establish a likely source of income and since the Government has not excluded all possible sources of non-taxable income to Smith, the Evidence is insufficient to raise any inference that the purported increases in net worth were taxable income.

THE EVIDENCE FAILS TO ALLOCATE THE ALLEGED INCREASES TO PARTICULAR TAX YEARS

Holland v. United States, Supra. also discussed the problem of allocating apparent increases in net worth to particular prosecution years.

> "While a steadily increasing net worth may justify an inference of additional earnings, unless that increase can be reasonably allocated to the appropriate tax year, the taxpayer may be convicted on counts of which he is innocent." Id. at 129. (emphasis added).

> "There is great danger that the jury may assume thatonce the Government has established the figures in its net worth computations, the crime of tax evasion automatically follows." Id. at 127-28

This particular problem was dealt with in Kleinman, supra. where the Court stated:

" Assuming that these items represent taxable income of defendant, the circumstances in the instant case are such that it cannot be said with any degree of reasonable certainty that this was income received by the defendant in the year 1949." Id. at 878.

It is clear that the Government is not permitted to "allocate summarily .....unaccounted for accretions to the year 1949." Id. at 879.

In the case at bar, the defendant did have a considerable amount of cash on hand in 1968 to make cash payments for his home and to buy furniture and automobiles. That year the defendant made considerable cash expenditures.

The Government maintains however that the defendant had taxable income in each of the three prosecution years. Yet from the evidence it is not clear in which year or years the defendant amassed all of his money. The showing of increased net worth for 1969 and 1970 might just as easily demonstrate the revealing of assets not necessarily their acquisition. In fact, as noted earlier, the increases in net worth in 1969 and 1970 correspond with the figures representing what SHP and Trio owed to the defendant. These loans or advances could have been made from funds acquired in earlier prosecution years.[2]

THERE IS NO EVIDENCE OF AN "ATTEMPT TO EVADE" INCOME TAX LIABILITY FOR THE TAX YEAR 1968.

The Government, relative to 1968, alleged that the defendant willfully failed to file an income tax

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2. This in no way is meant as a waiver of defendant's claim that he accumulated the money prior to 1968. It is only meant to bear on the sufficiency of the Government's case in chief.

return and that he failed to keep records in order to conceal that fact. However, there was no evidence at trial concerning Mr. Smith's books, bookkeeping, or any other matter insofar as 1968 is concerned.

The mere failure to file a return is not a violation of 26 U.S.C.A. § 7201. United States v. Mesheski, 286 F. 2d 345 (7th Cir. 1961). There must be an affirmative act coupled with the failure to file.[3] See Spies v. United States, 317 U.S. 492 (1943).

United States v. Tunnell, 481 F. 2d 149, 152 (5th Cir. 1973) states the rule for us.

> "As inferred by the Supreme Court from the words 'willfully attempts' in the statute, the second and third necessary elements for conviction are evil motive by the defendant Tunnell and an affirmative act to carry out his scheme to evade tax." (Citations omitted).

Without evidence of an affirmative act there is insufficient evidence to go to the jury regarding any violation of § 7201. There is merely evidence of a failure to file a return. See 26 U.S.C.A. § 7203.

In Spies v. United States, supra. the Court stated that there is a greater burden to prove wilfulness in a case charging a violation of § 7201 than in one charging a violation of § 7203. This burden has not been eliminated, although this Court, in United States v. Bishop, 93 S. Ct. 2008 (1973), in somewhat more incisive analysis, states that the affirmative act requirement goes to the issue of "attempting to evade" rather than wilfullness. Id. at 2017, n.8. Accepting, this dictum, coupled with the holding in Spies, it is clear that there must be an affirmative act to evade the tax to prove a violation of § 7201.

Hence, since in the case at bar there is no evidence that the defendant performed an affirmative act toward

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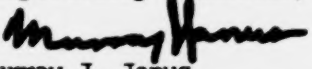
3. This argument assumes without conceding that there was a duty upon defendant to file in 1968.

"attempting to evade" his taxes in 1968, the evidence is insufficient to support the finding of guilty to Count I.

CONCLUSION

For the foregoing reasons, James E. Smith respectfully submits that the Petition for Certiorari should be granted to review the judgment of the United States Court of Appeals for the Fourth Circuit.

Respectfully submitted,



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UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 74-1257

United States of America,

Appellee,

versus

James E. Smith,

Appellant.

Appeal from the United States District Court for the Eastern District of Virginia, at Richmond. Robert R. Merhige, Jr., District Judge.

(Submitted July 1, 1974 Decided September 10, 1974)

Before CRAVEN, BUTZNER and RUSSELL, Circuit Judges.

Edward D. Barnes and Murray J. Janus on brief for Appellant; and Brian P. Gettings, United States Attorney, and Roger T. Williams, Assistant United States Attorney, on brief for Appellee.

PER CURIAM:

Tried to a jury, James E. Smith was convicted on all counts of a three-count indictment charging him with attempting to evade or defeat his federal income tax for the years 1968, 1969 and 1970 in violation of 26 U.S.C. § 7201. On appeal Smith asserts that there was insufficient evidence to support his convictions. Smith, who proceeded against by the Government under the net worth method, claims that the evidence failed to: (1) properly establish the opening net worth figure; (2) demonstrate that the Government adequately investigated Smith's possible sources of funds prior to 1968; (3) establish either a likely source of income or exclude all possible sources of nontaxable income; (4) properly allocate the increases in Smith's net worth among the years set forth in the indictment; (5) establish that Smith willfully attempted to evade payment of his income tax for 1968.

Upon careful examination of the briefs and the record, we conclude that the evidence amply supports the convictions under the net worth method. See Holland v. United States, 348 U.S. 121 (1954); United States v. Calderon, 348 U.S. 160 (1954); United States v. Newman, 468 F. 2d 791 (5th Cir. 1972), cert. denied, 411 U.S. 905 (1973); Mighell v. United States, 233 F. 2d 731 (10th Cir. 1956), cert. denied, 352 U.S. 832.

Accordingly, we dispense with oral argument and affirm the judgment of the district court.

AFFIRMED.

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-410

JAMES E. SMITH, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

After a jury trial in the United States District Court for the Eastern District of Virginia, petitioner was convicted of willfully attempting to evade and defeat his income tax for the years 1968, 1969, and 1970, in violation of Section 7201 of the Internal Revenue Code of 1954, 26 U.S.C. 7201. He was sentenced to concurrent terms of three years' imprisonment. The court of appeals affirmed (Pet. App.).

The prosecution was based on the net-worth method of proof. The evidence showed that petitioner's net worth increased as follows (Supp. Tr. 73-74):[1]

December 31, 1967	3,700.00
December 31, 1968	40,034.51
December 31, 1969	67,960.63
December 31, 1970	105,077.63

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[1] "Tr." and "Supp. Tr." refer to the primary and supplemental transcripts of the trial proceedings, respectively.

During those years, petitioner reported little or no income. His true income tax liability for 1968, a year for which he filed no tax return, was $12,970.61; for 1969, his true tax liability was $8,652.89, as compared with the $776.32 indicated on his return; and for 1970, it was $12, 358.57, compared with the $642 reported on his return (Supp. Tr. 83-84).

In this Court, petitioner makes five contentions: (1) that the evidence to establish his beginning net worth was insufficient; (2) that the government did not adequately pursue "leads" that he furnished; (3) that there was insufficient proof that the net worth increases arose from taxable income; (4) that the net worth increases were not properly allocated to the appropriate tax years; and (5) that there was no evidence of an affirmative act of evasion as to the year 1968.

1. The net worth starting point was established with reasonable certainty. The proof showed that at the end of 1967, when petitioner was 32 years old, his only assests were a motorcycle and a car worth $3,700 (Supp. Tr. 56-74). Despite petitioner's claim that he had by that time accumulated $50,000 in undeposited cash (Tr. 216, 241), the evidence showed that no such hoard could have been saved. Prior to 1964, petitioner had been employed first at parking garages in Washington, D.C., where he was paid no more than $1.10 per hour, plus tips (Tr. 207, 211), and then as a press cleaner, starting as an apprentice and working his way up to a wage of $3 per hour (Tr 214-215, 216, 240). Petitioner claimed that by the end of 1963, his alleged cash hoard of $50,000 was complete, although he admits that it had not been reported on his income tax returns (Tr. 214, 216, 241; Pet. 12). Petitioner testified that he hid his $50,000 in a box and never deposited it in any bank account or even considered

doing so (Tr. 241). From the latter part of 1964 until the early part of 1966 petitioner was unemployed (Tr. 242). Petitioner reported income of only $1,894.93 for the year 1966 (Tr. 242) and $4,368 for 1967 (Tr. 243).

2. Petitioner furnished no "leads" that required government investigation. He informed investigating agents that the most undeposited cash he had ever had on hand was between $20,000 and $30,000, which he and his wife had accumulated, but he could not remember when he had had it or where he had kept it, nor did he offer any explanation as to its source (Tr. 196). The government is required only to investigate leads that, if true, would tend to establish the taxpayer's innocence and that, further, are reasonably susceptible of being checked. *Holland* v. *United States,* 348 U.S. 121, 135-136.

3. The evidence established that the net worth increases arose from current taxable income. The government may proceed in either of two ways to make such a showing: (1) prove that the taxpayer had a likely source of unreported income *(Holland* v. *United States, supra,* 348 U.S. at 137-138); or (2) prove that the net worth increases did not arise from nontaxable sources, such as gifts or inheritances. *Massei* v. *United States,* 355 U.S. 595. The government here proved both. It proved that during the prosecution years petitioner had an interest in three different active businesses (Tr. 173-174, 176-178, 220-221, 223-224, 227); moreover, petitioner admitted to having gambled in the past on a rather extensive scale, and gambling is "an occupation with indeterminate possibilities." *United States* v. *Costello,* 221 F.2d 668, 672 (C.A. 2), affirmed, 350 U.S. 359. The government also gave petitioner credit for all nontaxable funds received by him or his wife as shown by the investigation (Supp. Tr. 79-80); petitioner admitted that he had never received any

inheritances, and his claim of having received gifts was vague and unsubstantiated (Tr. 179).

4. The evidence properly allocated the net worth increases to the appropriate taxable years. Petitioner's argument to the contrary is merely a restatement of his claim that his funds derived from an earlier cash hoard.

5. Finally, the government proved an affirmative act of evasion as to the year 1968. The proof showed that during that year petitioner had substantial dealings in currency (see, *e.g.*, Tr. 82, 88-89, 99-100), and the jury could well have found that this constituted "handling of one's affairs to avoid making the records usual in transactions of the kind, and * * * conduct, the likely effect of which would be to mislead or to conceal." *Spies* v. *United States*, 317 U.S. 492, 499. Moreover, since the prison sentences were concurrent and no fines were imposed, petitioner's contention as to 1968 is not sufficient, standing alone, to justify discretionary review. See, *e.g.*, *Barnes* v. *United States*, 412 U.S. 837, 848 and n. 16.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

DECEMBER 1974.